Internal Revenue Service

memorandum

CC:INTL-0363-89
Br5:CCooper

date: SEP 13 1989

to: John Rusey
Norm Schumacher
IE group E; 445

from: Bob Katcher BK
Carl Cooper

subject: [redacted] investment in [redacted]

This memorandum further develops your conversations with Kim Palmerino of this office regarding [redacted]'s investment in [redacted] or "Bank"). We have received from you a package consisting of certain [redacted] correspondence, a prospectus of [redacted] and certain quarterly statements of [redacted]

The information that we have been able to glean from those sources suggests that [redacted] conducted no more than de minimis banking activities and, thus, was not engaged in the conduct of a banking business within the meaning of section 904 (d) (2) (B).[1] Additional factual development is necessary to confirm our suspicions. If that is the case, and assuming that [redacted] was more than 50% owned by U.S. persons, then the separate limitation interest earned by [redacted] and paid over as dividends to its U.S. shareholders would retain its character as separate limitation interest under section 904 (d) (3).

Facts

[redacted] purchased [redacted] class A shares of [redacted] in exchange for $[redacted] on [redacted], [redacted] held those shares until [redacted], on which date all of its [redacted] shares were redeemed.[2] [redacted]'s only other activity

---

[1] All section and regulation references are to the IRC of 1954 and the regulations thereunder prior to the Tax Reform Act of 1986.

[2] If [redacted] is a calender year taxpayer, the fact that [redacted] redeemed its shares on such date is additional evidence of the tax-motivated purpose for the investment because the general effective date for the 1986 amendments to section 904 (d) is tax years beginning after December 31, 1986.

with regard to this investment was the execution of a proxy for the annual shareholders meeting on [redacted].

[redacted] is a Bahamian corporation formed by [redacted] and operating under a general banking license issued on [redacted].[3] [redacted] is subject to regulation by the Central Bank of the Bahamas, and all shareholders of [redacted] must be approved by the Central Bank of the Bahamas. The Central Bank gave blanket approval to all shareholders listed on a U.S. stock exchange.

[redacted] was authorized to issue [redacted] class A shares and [redacted] class B shares at a price of $[redacted] per share. Class B shares are the same as class A shares except that they are non-redeemable in order to satisfy the capital requirements of Bahamian law. [redacted] purchased all of the class B shares. Investors were required to purchase and hold a minimum of [redacted] class A shares. The shares were redeemable at book value.

The offering was structured as a private placement under U.S. securities law and was targeted at U.S. multinational corporations needing some "good" foreign source income. Indeed, the prospectus indicates that tax considerations were of first importance for potential investors. The "Summary of Placement" explains that the only reason to invest would be that the dividends from [redacted] purportedly could be used to absorb excess foreign tax credits, while a similar investment directly in interest producing assets would produce separate limitation interest.

All earnings of [redacted] less a management fee, were to be paid out monthly. This was mentioned as an "attractive opportunity for cash flow", which was supposed to be a benefit in addition to the tax advantages. This is at least disingenuous. The prospectus states that the overall investment return on [redacted]'s assets would be approximately equal to a blend of Eurodollar bid rates of investments with maximum maturities of 90 days, less the management fee. It is our understanding U.S. multinationals could realize the same return on similar investments without a management fee.

---

[3] It is unclear whether [redacted] is still "operating". If not, its transient existence may evidence that it was not a "real" bank, but merely an entity formed and availed of to attempt to pass on certain tax benefits.

All officers and directors of [redacted] were full-time employees of [redacted] at the same time. The [redacted] officers and directors of [redacted] that were resident in the Bahamas were employees of [redacted]'s [redacted] branch. [redacted] was operated under a management agreement with [redacted] pursuant to which [redacted] would provide "such managerial, technical, and administrative assistance and other services as are necessary for its [[redacted]'s] operations as a "bank" under Bermuda law. The management agreement also includes a power of attorney giving [redacted] authority to do whatever [redacted] might deem necessary in its discretion to conduct the business of [redacted]. As compensation, [redacted] received a monthly fee equal to [redacted] basis points of [redacted]'s assets. This fee accounted for substantially all of [redacted]'s operating expenses.

According to the prospectus [redacted] intended to engage in a variety of services such as taking deposits, making loans, and making Eurodollar and Eurocurrency bank placements. The prospectus states that initially most of [redacted]'s assets would consist of short-term Eurodollar placements with major international banks including [redacted]. [redacted]'s quarterly statements indicate that all of its loan portfolio consisted of Eurodollar loans made either directly or by means of loans which had been participated by [redacted]. There is no indication that any of these loans resulted from solicitations to the public by [redacted].

[redacted]'s deposit liabilities, which were guaranteed by [redacted], varied from $[redacted] to $[redacted]. Most likely [redacted] had nothing to do with soliciting these deposits and they were surely made only because of the guarantee.

Aside from these minimal deposits, [redacted]'s other liabilities consisted of dividends payable and its management fee. All of its shareholder equity was represented by contributed surplus because each month [redacted] paid out all of its earnings; certainly, a strange banking practice. Indeed, unlike most banks that rarely have as much as [redacted]% of their balance sheet attributable to capital because they want to leverage their balance sheet as must as possible, [redacted]'s capital was approximately [redacted]%.

Law

Section 904 (d) (1) (A) provides for a separate foreign tax credit limitation for certain interest. Section 904 (d) (2) defines the interest subject to the separate limitation

as including all interest except, among other things, interest derived in the conduct of banking, financing, or similar business. Section 904 (d) (2) (B).

In order to prevent the conversion of separate limitation interest into general limitation dividend income, Section 904 (d) (3) provides that dividends received from certain designated payor corporations shall be treated as separate limitation interest to the extent that the designated payor corporation has separate limitation interest. Included in the term "designated payor corporation" is any foreign corporation that is fifty percent or more owned by U.S. persons. Sections 904 (d) (3) (E) (i) and 904 (g) (6).

Section 1.904-4 (c) of the regulations defines a banking, financing, or similar business as a business the activities of which consist of one or more of the following activities carried on in transactions with persons situated within or without the United States:

(A) Receiving deposits of money from the public;

(B) Making personal, mortgage, industrial or other loans to the public;

(C) Purchasing, selling, discounting, or negotiating for the public on a regular basis, notes, drafts,checks, bills of exchange, acceptances, or other evidences of indebtedness;

(D) Issuing letters of credit to the public and negotiating drafts drawn thereunder;

(E) Providing trust services for the public;

(F) Financing foreign exchange transactions for the public; or

(G) Purchasing stock, debt obligations, or other securities from an issuer or holder with a view to the public distribution thereof; or offerings or selling stock, debt obligations or other securities for an issuer or holder in connection with the public distribution thereof, or participating in any such undertaking.

Section 1.904-4 (c) of the regulations also provides that the character of the business actually carried on during the taxable year shall determine whether it is conducting a banking, financing, or similar business.

There is little direct authority in this area. However, the authority suggests that an entity must carry on banking activities on a regular, not a de minimis, basis in order to satisfy the § 1.904-4 (c) requirements.

Rev. Rul. 82-209, 1982-2 C.B. 157, held that a controlled foreign corporation that qualified as a Montserrat Bank was not engaged in the banking business within the meaning of section 954 (c) (3) (D) of the Code.[4] The bank was subject to the banking laws of Montserrat. The bank, however, had no fixed business address from which banking services were provided to the public. The only indication of the bank's presence in Montserrat was that it received its mail at the office of a local agent, who performed only certain administrative functions. The bank did not have any facilities to receive deposits or provide trust services. It received no requests from the public to provide financing of any sort. The bank's sole activity consisted of making a loan to an unrelated U.S. person. Looking to the character of the business carried on during the taxable year by the bank the Revenue Ruling determined that the bank was not engaged in the conduct of a banking business because it had made a single loan, received no deposits, and had not conducted any banking activities with the public.

The information available to us suggests that [redacted] is not much different than the bank described in Rev. Rul. 82-209. [redacted] appears to have had no presence in the Bahamas or in the "banking" marketplace other than as a file folder in [redacted] branch. Apparently its business address was the same as [redacted]'s. [redacted] had no full-time (or part-time?) employees nor any independent facilities to receive deposits or process loans. It seemingly received no requests from the public to provide financing or other banking services. Moreover, the available information strongly suggests that [redacted] derived its income principally from investment, rather than banking, activities.

There are cases regarding the definition of a bank for other purposes of the Code. In Austin State Bank v Comm. 57 T.C. 180 (1971), acq. 1974-2 C.B. 1, the taxpayer was held to be a bank and not a personal holding company under section 581 (relating to the definition of a bank for purposes of sections 582 and 584). The taxpayer operated in

---

[4] The definition of banking for purposes of § 954 (c) (3) (D) and § 904 (d) (2) (B) are essentially the same. Compare §§ 1.904-4 (c) and 1.954-2 (d) (2) (ii).

an Indiana town of 3,500 people. It was subject to the Indiana banking laws. It accepted deposits from related and unrelated customers, made a small number of loans, maintained an office, kept regular office hours, employed two full-time employees, and offered standard banking services to the general public. In making its determination, the Tax Court decided that it was inappropriate to disregard the bank's deposit and loan activities with related parties because its business environment was limited to a very small community.

[redacted]'s situation differs significantly from Austin Bank. [redacted] did not operate in a small town business environment, but rather in the international banking market. Therefore, its banking activities should be measured against other "real" banks operating in the same market. [redacted] did not have full-time employees. It apparently had no physical presence at all and no other presence in any banking market through advertising, etc., by means of which it held itself out to the public for no indication that [redacted] had any of its own facilities for accepting deposits or performed on a regular basis any of the banking activities listed in the Prospectus.

In Magruder v. Safe Deposit and Trust Company, 121 F. 2nd 981 (4th Cir. 1941), the court held that the taxpayer was not entitled to an exemption from the limitation on capital losses in section 117 (d) of the Revenue Act of 1934 because a substantial part of the taxpayer's business was not the receipt of deposits from the general public that were similar to the ordinary, general liability, commercial deposits which banks receive. The taxpayer in this case was a trust company and most of the deposits it received were special purpose trust deposits made in connection with its activities as a trust company. Apart from deposits made by the trust company with its own banking department, the other deposits it received were limited to a few favored corporations, also for limited purposes. Although the [redacted] case does not involve the question whether a trust company is like a bank, Magruder does provide guidance relating to the issue of whether deposits are received from the general public. The information available suggests that [redacted], like the trust company in Magruder, did not receive deposits from the general public but rather from the favored few referred to it by [redacted].

Staunton Industrial Loan Corp. v. Commissioner, 120 F. 2nd 930 (4th Cir. 1941), found that the substance of an entity's business was determinative of its status as a bank and not its classification under state law. This is no different that the regulation's directive.

Conclusion

Based upon the information at hand, we would recommend that you treat the dividends [redacted] received from [redacted] as separate limitation interest, because [redacted] was not engaged in a banking, financing, or similar business within the meaning of section 904 (d) (3) (E) (i) and the regulations thereunder. Instead, [redacted]'s business was more in the nature of a mutual fund. This conclusion is based on the following (not necessarily in order of importance):

1. The Bank's balance sheet, such as the disproportionate amount of its capital compared to its liabilities (if any) and its lack of retained earnings.

2. The Bank's management arrangement.

3. The Bank's dividend policy.

4. The Bank's return on its assets.

5. The Bank's apparent lack of public presence, evidenced by its lack of employees, offices, and advertising.

6. The Bank's de minimis (if any) banking activities probably resulted from its intimate relationship with [redacted] and its [redacted] branch, as opposed to the Bank's own activities.

6. The Bank's purported deposit liabilities were guaranteed by [redacted].

7. Rev. Rul. 82- 209 and the other authorities cited above.

8. The tax-motivated reasons for the Bank's existence and the manner in which it promoted itself to investors.

If you have any further questions please call either Carl Cooper or Bob Katcher at FTS 566-6795.